CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 283

April 23, 1965

REORGANIZATION: EXCEPTION FROM COMMENCING CORPORATION PROVISIONS

Syllabus:

There are four corporations factually involved in this problem. First there is A, a Delaware corporation, which is now and was during the years mentioned herein, duly qualified and entitled to do business in California; that it was, and now is engaged in the business of the manufacture and sale of electrical and/or electronic components.

Second, there is B, a California corporation. Prior to March 27, 1956, it conducted a business similar to A.

Third, there is C, a California corporation. Prior to March 27, 1956, it conducted a business similar to A.

Fourth, there is D, a California corporation. Prior to March 27, 1956, it conducted a business of selling, at retail and wholesale products of A, B and C.

In March, 1956 A filed with the California Secretary of State a certificate evidencing the merger of B, C and D into it.

Prior to the merger A was subject to Chapter 3 of the Bank and Corporation Tax Law (Corporation Income Tax) and the merged corporations were subject to the Bank and Corporation Tax Law. The result of operations for the entire income year 1956 of the three merged corporations was combined in a single franchise tax return for the income year 1956 with the operations of A. All three of said merged corporations filed franchise tax returns covering their operations for the income year 1955, and paid the franchise taxes disclosed by the returns.

The audit staff of the Franchise Tax Board determined that the merger of B qualified as a reorganization under Section 23251 of the Bank and Corporation Tax Law; that the merger of C and D did not qualify as reorganizations under Section 334(b)(2) of the I.R.C., thus obtaining a "stepped up" basis for the assets acquired in the merger.

Under Section 334(b)(2) I.R.C., (Section 24504(b)(2) B & CTL-Kimbell-Diamond situation) B & C were regarded as a taxable exchange at acquisition and not a reorganization excepted from the commencing corporation provisions.

An assessment was made in June 1960, pursuant to Section 23224 of the Bank and Corporation Tax Law which assessment was protested.

Does the commencing corporation provisions apply to a surviving corporation of three simultaneous mergers, of which only one constituted a statutory reorganization?

The California Supreme Court (in San Joaquin Ginning Co. v. McColgan, 20 C. 2d 254) stressed and applied the rule of liberal construction in the interpretation of the terms "reorganization", "merger" and "consolidation" in the Bank and Corporation Tax Law. The instant problem definitely supports the court's conclusion that a liberal construction is necessary in determining the intent in the use of the term "reorganization" as applied to cases of this character.

Section 13(g) of the 1935 Bank and Corporation Franchise Tax Act and all subsequent Bank and Corporation Franchise Tax statutes have provided that the commencing corporation provisions shall not apply to a bank or corporation which commences to do business in this State, pursuant to a reorganization.

The reorganization provisions were designed to prevent tax avoidance through the shifting of assets between corporations when the ultimate ownership of the assets before and after the transfer remains the same.

This problem presents precisely the type of situation to which the reorganization provisions were designed to apply.

A acquired the stock of B in 1953; of C and D in 1955. Thus, before 1956 A controlled the business and property of the merged corporations by virtue of its ownership of all their stock. After 1956 it still controlled the identical business and property by virtue of its ownership of all the stock of the merged corporations. The business and property transferred never ceased being under the ultimate control of A subsequent to March 1955.

The three merged corporations filed separate franchise tax returns of their 1955 operations and A, the surviving corporation, filed a single franchise tax return disclosing the 1956 operations of the merged corporations as well as its own operations. Thus, all years and all income has been accounted for consistent with the intended purpose of the reorganization provisions.

The principles that required the courts to announce the Kimbell-Diamond doctrine appear to apply to the C and D mergers, nevertheless a construction of the term "reorganization" for Section 23252 purposes, should be given so as to operate in a manner in conformity with the intended purpose, i.e., avoid a construction which leads to results that are arbitrary and not in conformity with the express purpose for which the section was created.

The entire transaction is a practical merger as distinguished from a statutory merger and should be reorganized as such for Section 23252 purposes.

The merger of A and B is conceded to qualify as a statutory reorganization. Since Section 23252 excludes statutory reorganizations from the commencing corporation provisions an application of the commencing corporation provisions to the A and B reorganization is contrary to the law on its face and subject to recomputation under the Bank and Corporation Tax Law.

The fact that the C and D mergers were not technical statutory mergers does not affect nor interfere with the A and B reorganization. It points up the necessity for treating the C and D mergers as practical mergers and except the entire transaction from the commencing corporation provisions to avoid arbitrary results.